Testimony of
Mr Stephen Edge
Before the
Committee on Ways and Means
U.S. House of Representatives

Hearing on
How Other Countries Have Used Tax Reform
To Help Their Companies
Compete in the Global Market and Create Jobs

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Chairman Camp, Ranking Member Levin and Members of the Committee.

Personal Background

1. My name is Stephen Edge and I am a qualified solicitor specialising in corporate tax in the UK.

2. I appear before you today on my own behalf and not on behalf of my firm or any client. The views I express reflect my own perspective of a complex world based on my own personal experiences. I acknowledge that others may have a different perspective.

3. My formal legal education commenced with a Law Degree from Exeter University, England in 1972.

4. I joined Slaughter and May in 1973, after a six-month course leading to successful completion of what, in US terms, are effectively the bar exams, and then spent two years doing practical work experience (now called a training contract, then called articles) before qualifying as a solicitor in 1975.

5. On qualifying, I joined the Tax Department of which I have been a member ever since. I became a partner in the firm in 1982.

6. It is a privilege to have been invited here to testify on how the UK has responded to a number of external pressures by setting itself the objective of giving the UK "the most competitive tax system in the G20".

Current Practice and Past Experience

7. My practice has always spread across the full range of UK corporate taxes in a multinational context. My firm acts for large multinationals, whether based in the UK or elsewhere, and is involved in complex transactions in either the financing or M&A area. The Tax Department supports this effort and also has its own tax consultancy clients (many of them multinationals). I personally act for a number of large UK multinationals - and have, for many years, advised a number of overseas (principally US) multinationals too. In the course of my work, I have spent a great deal of time over the years in policy discussions with HM Revenue & Customs (**HMRC**) and government - and also, of course, in tax controversies which test the limits of, and underlying policies behind, tax legislation.

8. My M&A experience means that I have been involved in very many discussions about the impact of tax on corporate acquisitions or disposals and, in particular, on the impact that various tax attributes can have on the economics or pricing of a deal.

9. This has often, of course, involved discussions between parties to a merger as to where the new group holdco should be located - in relation to which tax is an important but not usually a conclusive factor. There are many other aspects to be taken into account in deciding where a holdco should be located but, all other things (such as corporate governance, the practical aspects of staff location, capital markets etc) being equal, corporates will usually, of course, choose the most benign or accommodating jurisdiction in tax terms.

10. Although my qualifications and the work of the firm restrict the formal advice I give to the UK tax and legal aspects of a transaction, I do of course regularly deal, and exchange ideas, with practitioners from other jurisdictions and I am, therefore, aware of what is being done in the multinational tax area in a number of other developed jurisdictions (particularly the US and other countries in Europe).

Focus of Testimony

11. In this testimony, I will be focusing on: -

    (a) the impact the domestic tax regime can have on multinationals;

    (b) the areas in which jurisdictions try to compete with each other to make themselves more attractive in tax terms to multinationals; and

    (c) in particular, recent thinking behind the introduction of an exemption system in the UK on foreign dividends and the decision not to introduce additional rules relating to the allocation of interest or other overheads connected with a foreign acquisition. (I say “additional rules” here because, like many jurisdictions, the UK has provisions which prevent corporates taking deductions for expenses that do not “belong” in the UK because they do not relate to a UK trade or business. It has transfer pricing rules which ensure that proper charges are made for services provided to affiliates and there is also a plethora of interest related tax avoidance rules).

12. There are, of course, other areas of tax law which are directed at influencing business decisions as regards the UK (such as tonnage tax for shipping, the new patent box for R&D businesses and accelerated depreciation for capital investment) but they are not relevant in this context.

What a Competitive Tax Regime for Multinationals Requires

13. A competitive tax regime for multinationals is what the last two UK governments have said they are aspiring to create. The key features of any multinational tax regime, when comparisons are being made between different jurisdictions, are:

    (a) the existence or otherwise of withholding taxes on distributions to shareholders;

    (b) the domestic tax rate (as it applies not only to domestic trading profits but also to income derived from international operations in the form for example of management charges, consideration for the use of IP and returns on funding provided to overseas subsidiaries);

(c) the scope and effect of any interest allocation rules or other restrictions affecting overseas investments;

(d) the treatment of overseas dividends - whether there is an exemption system on foreign dividends or a foreign tax credit system;

(e) the fact that the jurisdiction offers a good tax treaty network so as to reduce withholding taxes and other tax restrictions on remittances of profits from overseas;

(f) the existence or otherwise of a good participation exemption covering capital gains on realisation of investments in subsidiaries or on the repatriation of capital from overseas; and

(g) the impact of any controlled foreign company (or **CFC**) rules.

14. In terms of managing any multinational's effective tax rate (and also producing tax synergies from any acquisition or merger) the most important of these would obviously be (a) the domestic tax rate (b) the existence or otherwise of interest allocation rules (c) the tax position on the remittance of profits and (d) the scope of any CFC rules. These will, therefore, be the particular areas of focus in this testimony.

Recent UK Developments

15. In recent times, the UK has: -

(a) reduced its domestic corporate tax rate with a commitment to reach 23% by the end of the current parliament. (At Appendix A, I show what the UK corporate tax rates have been since corporation tax was introduced in 1965);

(b) after full consideration, decided not to introduce further interest restrictions and, in particular, not to follow the model recently introduced elsewhere in Europe of restricting allowable interest expense to a percentage of locally taxable income;

(c) changed from a foreign tax credit system to an exemption system on foreign dividends (2009); and

(d) introduced what is effectively a participation exemption on disposals of shares in companies which are trading or part of a trading group (the Substantial Shareholding Exemption (**SSE**) regime introduced in 2002).

16. The UK has a good double tax treaty network and has had no withholding tax on outbound dividends since the Advance Corporation Tax (or **ACT**) system was introduced in 1972.

UK's Position in the Commercial World

17. The UK obviously has an important financial centre and key positions in other related businesses. For its commercial and industrial base, the UK has operated successfully for many years on the basis of (a) a mercantile economy with (b) very open capital markets.

18. Having a mercantile economy means that the UK encourages its business community to stay in the UK and gives incentives for others to establish themselves and/or invest here. Business flexibility - and, of course, all the other attributes that can be offered through UK corporate governance, infrastructure etc - have been seen to be key in this regard. You need to have the right general environment for tax to become a potential swing factor. Like any market place, you first have to attract the traders to set up business and then make it attractive for people to come to the UK and do business with them.

19. Open capital markets mean that, subject to competition restrictions, there is no reason why a UK public company cannot be taken over and reorganised by a foreign competitor. By the same token, both EU law and natural UK inclinations mean that UK companies are free to move their corporate residence offshore. Again, this creates an enterprise economy which must encourage business in order to be successful. The decision (subject to competition restrictions) on any takeover bid or on whether companies should continue to be parented in the UK or move their residence or be acquired by a non-resident third party acquirer is left entirely to commercial and capital markets considerations.

20. Having said that, the UK has a natural desire to retain (and, if possible, increase) the large number of multinationals that are currently based in the UK, whether or not they carry on significant operations here. It has thus gone to some trouble to attract other jurisdiction's multinationals to set up business in the UK and to base their headquarters here.

Efforts to Encourage Multinationals to Operate In UK

21. As will be seen from Appendix A, corporate tax started off at a 40% rate when it was introduced in 1965. In 1972, some radical changes were made to the system so that the rate went up to 52% but withholding tax on dividends was eliminated and instead the ACT system was introduced.

22. This meant that companies had to make a payment on account of their own tax liabilities when they had paid a dividend. That payment then served a double duty - first, it was offsettable against a company's own tax liabilities when they arose and second it "franked" or, in financial terms, covered the tax credit that was given to the shareholders which could be offset against their own liabilities or repaid.

23. There were two key problems with this: -

    (a) the first was that there was a significant cost for inward investors (particularly from the US) who had benefitted from a reduced withholding tax rate under the treaty (taking the UK tax take on remitted profits down to around 43%) but would not be able to benefit from the ACT credit. This was amended by ACT credit refunds under the new US/UK treaty negotiated in 1975 which provided for an incremental dividend linked return to incoming US multinationals and at the time maintained the effective 43% rate; and

    (b) the fact that ACT had to be paid regardless of whether or not taxable profits arose in the UK gave rise to a considerable cashflow cost for multinationals based in the UK whose income was mainly sourced from overseas so that, after foreign tax credits, they had no domestic tax base. (It had a similar effect, of course, on loss making companies whose operations were wholly carried on in the UK). The multinational community complained about this provision of "permanent interest free finance" to the government for many years.

24. In 1994, a consultation on the ACT system produced some modifications through the introduction of international holding companies (**IHC's**) and a special form of dividend (foreign income dividends or **FID's**) which enabled UK based multinationals with substantial amounts of overseas income to pay through dividends that were not subject to ACT and so avoided the cost of paying UK taxes they might not recover. This was a deliberate attempt by the government at the time to continue to maintain UK tax competitiveness in the multinational arena.

25. In 1997, the domestic impact of repayable tax credits to pension funds and others meant that the incoming government took steps to abolish the ACT system completely - though interestingly the corporate tax rate was not then restored to its previous level and nor were withholding taxes reintroduced. A low tax rate on corporate profits and no further tax on distribution were seen as major advantages of operating in the UK.

Previous Consultation on the Treatment of Foreign Dividends

26. In 1999, the government consulted on whether or not an exemption system for foreign dividends should come in. It was feared by most UK multinational tax directors at that time that an exemption system could only come in if there were interest restrictions and they concluded that a tax credit system with no interest restrictions was better than an exemption system with interest restrictions. The status quo was thus maintained.

Parallel Developments through the European Court of Justice

27. On a parallel track during the 1980's and 1990's, the impact of the European freedoms on domestic tax law as it affected multinationals based in the UK was being explored through the courts. Two particular cases were relevant in this area: -

    (a) the **Cadbury** case *(Cadbury Schweppes plc and others v Inland Revenue Commissioners (Case C-196/04) [2006] ECR I-7995)* which said that the UK could not impose CFC rules on UK groups which had properly and fully established business operations in another European country without contravening the fundamental freedoms by creating a differential between domestic and overseas investment; and

    (b) the **FII** litigation (*Test Claimants in the FII Group Litigation v Revenue and Customs Commissioners [2010] EWCA Civ 103*) which broadly said that the UK could only have a domestic exemption system on corporate dividends and a foreign tax credit system on overseas dividends if "the two did the same thing." Since the domestic exemption system (which had been a feature of corporate tax since inception) accorded the exemption regardless of whether or not there were any underlying taxes, this clearly meant that the UK had to conform the treatment of domestic and corporate dividends.

28. Resolving these two disputes, where HMRC pursued litigation to defend its position vigorously, clearly presented the government with some policy challenges going forward - and also some potential exposure in relation to taxes still disputed for past periods. In theory, the disputes could have been resolved by conforming UK law and practice with the then current foreign practice but that would have had severe practical problems so the disputes rumbled on for a period.

CFC Aspects

29. For several years, multinationals filed on the basis that Cadbury was good law in the UK (European law having direct effect regardless of what the UK's statute said) and there was an effective stand off between multinationals and the government. Matters with the UK multinational community came to a head in 2007 when a consultative document *("Taxation of the foreign profits of companies" June 2007)* attached as Exhibit I proposed "modernising" the treatment of the UK CFC regime in a way that many thought was not consistent with Cadbury and saw as intended to increase the UK corporate tax yield by taxing offshore passive income received by CFC's of UK multinationals.

30. The reaction to this was quite extreme - some companies emigrated and left the UK (see Appendix B) but others said that they were only going to stay if the CFC rules were not only made to comply with EU rules (as Cadbury required) but were also made more competitive in global terms.

31. The government's response to this was to seek to pacify the UK multinational community so that they would stay in the UK by promising to deliver a more competitive system and address, in particular, the CFC concerns that had been raised. In taking this position, the government was, no doubt, well aware of the fact that EU law prevented them introducing something similar to the anti-inversion rules in the US.

32. Consultation with business on an open and active basis has radically improved. As a result, discussions on CFC reform took place during the final years of the Labour government and have continued in the first year of the new Coalition government.

33. The Coalition government has now proposed the introduction of limited reforms of some significance, under which (inter alia) offshore treasury companies are allowed to pay effectively a low rate of tax (equity funding being permitted up to 75% of their capital base) and has promised more to follow. (The patent box was part of this package).

Dividend Exemption

34. In 2009, the decision was made that conforming domestic and foreign dividend treatment by exempting most corporate dividends (with some limited tax avoidance related exemptions) would be the answer both to EU law pressure and to the clamour from the multinational community for a more competitive UK tax system for multinationals. Legislation was introduced to bring this into effect. This contained no interest allocation rules - though I discuss below the introduction of this at the same time of a worldwide debt cap.

Corporate Tax Rate Reductions Continued

35. Within a short period of taking office, the Coalition government announced that the domestic tax rate is to be reduced progressively over the period of this parliament to 23%.

Consideration of Interest Allocation or Other Similar Restrictions

36. When the domestic tax rate discussions were taking place, there was considerable discussion as to whether or not this should be accompanied by interest allocation restrictions (perhaps along the German lines). There was, however, a clear policy decision by the government (*'Corporate Tax Reform: Delivering a More Competitive System' November 2010* attached as Exhibit II) that the fact that the UK had no interest restrictions was an attractive part of the multinational package and should continue.

37. It could have been said, of course, that the UK already had more than adequate protection against "debt dumping" or excessive or inappropriate UK interest deductions. There are longstanding rules which differentiate between debt and debt which has equity-like features. The UK has had thin capitalisation rules for over 30 years now. In 1996, a specific anti-avoidance rule for interest expense was introduced (looking at the purpose of a particular borrowing). Finally, more recent legislation has been introduced to deal with hybrid debt in circumstances where tax is driving the transaction (2005) and a so-called worldwide debt cap which seeks to ensure that UK parts of a global group do not have more debt than the group as a whole (2009). (Interestingly, the worldwide debt cap rules were primarily directed at upstream loans - of which more below.)

Other Protections Against Profit Diversion

38. In terms of protecting the UK tax base (whether under the existing regime or in previous times when we did not have an exemption for offshore dividends), transfer pricing and exit charge provisions prevent UK companies entering into artificial transactions with overseas affiliates or transferring assets at less than market value to overseas affiliates.

39. As already mentioned, the UK also has rules which prevent UK companies taking a deduction for expenses that do not really relate to its business - so employing the senior management of on overseas affiliate in the UK and trying to deduct the expense whilst not recognising any income would be problematic under those rules even if it were not caught by the transfer pricing provisions.

The CFC Implications - History

40. Remember, first of all, that the government faced two pressures when this process began - one was to meet the demands of the UK multinational community after the 2007 furore and the other was to make UK law conform with European law (which, as already mentioned, could be done in one of two ways).

41. I will deal first of all with the history in order to put the discussion that follows into context. In 1984, when the CFC rules were introduced for the first time, provisions were put in to counter transactions where companies with so-called passive or artificially manufactured income offshore did not remit it to the UK. This would catch royalty income, financing income, some intra group transactions and some foreign holding companies. A number of exemptions were built into the CFC rules when they were introduced so that, as was said at the time, they would be operated as anti-avoidance rules only and would not impinge on normal corporate operations. With that in mind, they were limited to income profits and not capital gains - and still are.

42. Inevitably, however, things moved in a different direction over time. First, taxpayers and their advisers manipulated the rules so as to "hide" some offshore income that might otherwise be vulnerable to apportionment under the CFC provisions. The tax authorities also began to broaden the scope of the rules in response to such perceived abuses and also faced with general tax gathering pressures.

43. This all came to a head in 2007, as mentioned above, when taxpayers perceived that there was a clear attempt to extend the scope of the rules so that they picked up all foreign passive income or returns from mobile capital regardless of the underlying motivation and also without regard to limitations imposed under EU law.

The CFC Implications - Recent Changes

44. As will be seen, the CFC rules (whether by virtue of their incompatibility with EU law, litigation on which was really just a symptom of the general discontent, or because of their impact on UK based multinationals' ability to manage their effective tax rate) have been at the heart of the debate between UK business and government over the last few years – but the foreign dividend exemption and interest allocation (which are, of course, related topics) were never far away from the debate.

45. All these matters then had to be brought to a head in reaching a compromise in relation to past disputes and building a competitive regime for the future that met both the government's and the business community's objectives.

How to Deal with Existing Overseas Cash Balances

46. In a period when, in order to maintain a competitive effective tax rate, UK groups had naturally built up offshore passive income which was lowly taxed and balanced out higher taxes paid in downstream jurisdictions where they were operating in averaging out their global rates (usually somewhere in the 20-30% range), large amounts of overseas cash had built up in the period after the UK abolished exchange controls in 1979. There was no way of forcing UK companies to repatriate that cash. The CFC regime was the only mechanism available to the tax authorities. But it was only effective in periods in which income accrued.

47. (It is not always the case, of course, that offshore surplus cash is income that is simply not being dividended back to the UK. With many groups, offshore cash balances may arise from one disposal and may be held in anticipation of another future acquisition. Requiring a UK group to bring any overseas cash back to the UK and pay tax on it before re-investing it offshore obviously creates tax friction in a multinational's operations.)

48. Many UK groups had, prior to the exempt dividend rules coming in, thus lent overseas surplus cash in one part of their overseas group to another part of their group where it was needed. Often such cash was lent back to the UK (where the main treasury operations might be located). The UK has never had corporate tax rules which have re-characterised such an upstream loan as a dividend.

49. In HMRC's eyes, upstream loans not only brought the cash here without an income charge but they also created a deduction which eroded the UK tax base. That second point could have been dealt with through existing anti-avoidance rules in extreme cases but it was finally addressed when the worldwide debt cap rules came in.

Transition to Exemption

50. At the time of the discussions about dividend exemption, the existence of overseas cash balances was thus well known to both sides in the debate and the question arose as to whether there should be some division between past profits and future profits. There was clearly concern within government that past untaxed profits should not be brought back tax free, especially when they might be the fruits of CFC planning. Many commentators pointed out, however, that the idea that the government would collect tax on those unremitted amounts was illusory. Unless there was a sensible settlement on the CFC rules, many large groups would leave the UK (the threat was a real one) and so those overseas unremitted profits would never, in fact, be repatriated. The government decided, probably for practical reasons, to make no distinction.

Acceptance of Territoriality as the Guiding Principle

51. Out of all this emerged the concept of territoriality as the guiding principle to a settlement. The decision was that the UK should only tax income arising within its territory unless there was evidence of abuse. That abuse would be protected through existing rules (the transfer pricing regime etc) and also through a CFC regime which would deal with "artificial diversions of profits" in a way (yet to be fully disclosed) that complied with EU rules.

52. This was a key step along the road towards the currently proposed regime, which UK business seems inclined, subject to seeing the final detail, to accept as enabling it to compete globally with other companies in similar business areas who have effective tax rates lower than UK multinationals.

53. (As many multinationals have argued, without a competitive effective tax rate, companies are unable to deliver shareholder returns that match those of their overseas competitors. They are also often unable to make acquisitions when faced with competitors who apply a lower tax rate to income that they are acquiring and can thus afford to pay a higher purchase price. Any multinational which stops growing will eventually become vulnerable to take over itself. In the past, UK companies who have been taken over have found that their operations have been restructured so that areas of the group which were a problem in UK CFC terms are moved "out of harm's way" - producing, tax synergies for the purchaser.)

54. The decision on interest apportionment could clearly, in theory, have gone either way - but the basis of the decision was to encourage (within reason) overseas enterprise when that made more business sense than domestic expansion. The government will obviously keep a weather eye on this situation to see how the policy performs.

55. The decisions on CFC amendment and dividend exemption go hand in hand. They could be characterised purely as a response to the EU playing field levelling. But, as already mentioned, other solutions to EU compatibility were theoretically available (more clearly on dividend exemption). So, the better view must be that this is a genuine desire to have the most competitive G20 regime.

56. Having said that, of course, tax is only part of the total package that any business will consider in making investments or locating itself. What the government has tried to do is take tax out of the equation when those decisions come to be made. A low tax rate may assist domestic growth - but, if other factors point in favour of overseas expansion, the UK tax system will not discourage that in tax terms by seeking to cancel out the overseas benefit.

57. Finally, a major factor in business's willingness to trust government when it promised to deliver on international tax reform was the much improved relationship between HMRC and the taxpaying community. Greater transparency and openness has had benefits for both sides.

Conclusion and Balance of Views

58. There is no standard or perfect tax system. Politics and economics will mean that each jurisdiction has different constraints and objectives.

59. There are some who would say that multinational companies have too much influence with government and that the currently proposed system in the UK discriminates against companies with wholly domestic operations who might be seen to pay higher effective tax rates on their total profits than those who engage in multinational operations and can thus benefit from lower overseas rates. By making multinational companies pay more UK tax on their overseas profits, they would argue, the incentive to divert profits

overseas and employ people overseas rather than in the UK would be removed. Any other system is "unfair" in their eyes.

60. Those (including me) who support the current system see it as a pragmatic response to the practicalities in a world where competition is fast moving and truly global. As already mentioned, the European problems could, in theory, have been resolved in a different way. What has, therefore, driven the UK towards this solution is the desire to enable its national champions to compete and also, in the mercantile tradition, to attract more multinationals to conduct their operations from the UK. Commentators have pointed out that a company's tax contribution to an economy should not just be measured by references to corporate taxes paid.

61. Successful companies in the UK are likely to want to grow overseas and, if they do so, they will eventually become multinationals. If the UK has a regime which encourages multinationals, then its national champions will flourish and that should, it is argued, be to the benefit of the UK economy. The alternative with an open economy like the UK's is to see multinationals grow in other jurisdictions because your own are made uncompetitive and then have to face the possibility that your own corporate base in the UK becomes controlled by multinationals operating from other jurisdictions and with their own business agenda.

62. There were clearly a whole host of political and economic decisions that underpinned the eventual decision but the competing arguments were clear. They were resolved in favour of a more competitive regime, leaving UK based multinationals to pay the same rate as everyone else on their UK corporate profits but not have to face UK charges on overseas profits unless and until remitted in non-tax exempt form (i.e. not as dividends or as a capital repayment exempt from tax under the SSE regime). UK based multinationals were, therefore, put in a position where, if the business case supported this, they could expand overseas without necessarily having to worry about the UK tax implications.

63. Any government will obviously be concerned to protect its domestic tax base but, as explained above, it looks as if there are protections in place in the UK to do that already - and further are envisaged under the full CFC amendments when they are introduced.

64. (In some ways, the current regime harks back to previous UK regimes where foreign income was only taxed when remitted and could otherwise remain outside the UK tax net.)

Appendix A

United Kingdom corporation tax rates since 1965	
Year	Standard rate
1965-69	40%
1969-70	45%
1970-71	42.5%
1971-73	40%
1973-83	52%
1983-84	50%
1984-85	45%
1985-86	40%
1986-90	35%
1990-91	34%
1991-97	33%
1997-99	31%
1999-08	30%
2008-11	28%

Source: The Institute for Fiscal Studies

Appendix B

HMRC figures would suggest that 22 companies left the UK specifically for tax reasons since 2007/08. Of those that emigrated a few were prominent business including the advertising company WPP, publishing firm UBM, and pharmaceutical company Shire. Several of those that left were likely to be FTSE100 or FTSE250 companies which may have paid significant amounts of UK tax.

The HMRC figures will not, of course, take into account figures of companies which would have considered setting up in the UK but did not as a result of unfavourable tax changes. In addition, the figures are only likely to capture companies which declared to HMRC (or to the public (as in the case of Shire, UBM and WPP)) their intention to leave for tax reasons. It is quite evident that the majority of companies would not make a specific declaration to HMRC that they are leaving the UK for tax planning reasons and there is no such requirement for them to do so.

Companies leaving the UK specifically for tax reasons	
Year	Number of companies that emigrated
2007/08	1
2008/09	10
2009/10	7
2010/11	4

Source: HMRC